

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

(Mark One)

☒ Annual report pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934 (Fee Required)  
For the fiscal year ended December 31, 2003

☐ Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 (No Fee required)  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-12254

**SCIENTIFIC TECHNOLOGIES INCORPORATED**

Incorporated in Oregon

IRS Employer Identification Number: 77-0170363

Address of principal executive offices:  
6550 Dumbarton Circle, Fremont, CA 94555  
Telephone: (510) 608-3400

Securities registered pursuant to Section 12(b) of the Act: None  
Securities registered pursuant to Section 12(g) of the Act:

<u>Title of Class</u>	<u>Name of each exchange on which registered</u>
Common Stock, \$.001 Par Value	NASDAQ National Market System

Indicate by check mark whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act during the past 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).  
Yes ☐ No ☒

The aggregate market value of voting stock held by non-affiliates of the Registrant, based on the closing sales price of Common Stock on June 30, 2003 as reported by the NASDAQ Market System, was approximately \$6,534,066. Such amount excludes shares held by registrant's current directors and officers and by each person who owns 5% or more of the outstanding Common Stock in that such persons may be deemed to be "affiliates" as that term is defined pursuant to the Rules and Regulations of the Securities Exchange Act of 1934. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of the Registrant's Common Stock outstanding as of March 3, 2004 was 9,711,153 shares.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's definitive Proxy statement to be filed with the Securities and Exchange Commission in connection with the Company's 2003 Annual Meeting of Shareholders ("the Proxy Statement") are incorporated by reference in Part III of this Form 10K.

**PART I**

## **Item 1. BUSINESS**

*This Annual Report contains forward-looking statements that involve risks and uncertainties. The statements contained in this Annual Report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Factors that could affect our actual results include the level and timing of customer orders, the mix of products sold, fluctuations in sales of complementary third party products with which our products are sold, the timing of operating expenditures, general economic conditions in the U.S. and abroad, particularly in Asia and Europe, competition, our ability to introduce successful new products and other factors. You should carefully read the factors discussed in this Annual Report under the caption “Factors That May Affect Future Results.”*

*These forward-looking statements reflect management’s view only as of the date of this Annual Report. You should also carefully consider the risk factors described in other documents that we file from time to time with the Securities and Exchange Commission.*

### **Overview**

Scientific Technologies Incorporated designs, manufactures and distributes electrical and electronic industrial controls such as machine safety and automation sensing products. Our product lines include safety light curtains, safety interlock switches, safety relays, profiling scanners, factory automation sensors, controls, fiber optics, power monitoring, safety mats, safety contact strips, non-contact ultrasonic sensors and controllers, pressure transducers and other electronic equipment supplied to industrial automation, commercial and defense customers.

We were incorporated in Oregon in 1979. Eighty-six percent (86%) of our capital stock is currently held by our parent corporation, Scientific Technology Incorporated, a California corporation.

We are organized into two product groups, Safety Products and Automation Products, within two business segments. The two units maintain separate operating facilities, engineering and support organizations, which help provide more customer-centralized sales, product knowledge and application expertise directed at the unique needs of these focused markets. This organizational structure was initiated in 2000 to allow us to better target our products based on each group’s area of specialization, customer-focused applications and products.

Our corporate Internet address is [www.sti.com](http://www.sti.com). At this website, we make available free of charge our annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. The information found on our website is not part of this Form 10-K. In addition to our website, the SEC maintains an Internet site at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding us and other issuers that file electronically with the SEC.

### **Our Products and Markets**

## 1. Safety Products Group:

a. Safety Light Curtains. Our leading product group, which accounted for over 80% of our sales in 2003, 2002 and 2001, is a family of optical guarding products, also called presence sensing devices or safety light curtains, used to safeguard personnel in manufacturing environments against injury caused by robots and automated machinery. We offer several product variations, providing customers with a broad line of optical guarding solutions.

Safety light curtains consist of separate transmitter and receiver units. The transmitter emits a "curtain" of harmless infrared light beams in front of the hazard area. When one or more of the beams are blocked, this is detected by the receiver and the light curtain sends a stop signal to the guarded machine. Light curtains are extremely versatile and can guard areas that are more than 100 feet wide. By the use of mirrors, the light beams can be diverted around corners to surround multiple sides of a machine. Safety light curtains are available with different light beam spacings, which make them suitable for many applications. The spacing of the infrared light beams, and the optical design employed determine the resolution, or object detectability of the safety light curtain.

We manufacture and market a family of light guards called the MiniSafe, designed for inclusion in systems offered by original equipment manufacturers, or OEMs, and other end user applications. Depending on the model selected, MiniSafe light curtains are available in incremental sizes ranging from approximately 260 millimeters to 2,100 millimeters in coverage height. The operating distance, the distance between the transmitter and receiver, is up to 20 meters. These products are offered in various configurations with many features to meet a wide variety of machine guarding applications.

Applications for safety light curtains are found in a variety of manufacturing environments. Our customers use safety light curtains to guard a wide variety of hazardous applications including automotive assembly lines, robot work cells, semiconductor production equipment, metal stamping and forming, food processing, aircraft manufacturing, photographic film production, tire manufacturing and home appliance production.

The MicroSafe MC4700 series light curtain was introduced in 2001. This product features an ultra-compact transmitter and receiver that offers protected heights from 100 millimeters to 1,798 millimeters. Superior response time and excellent resolution, allow the MC4700 to be mounted closer to the danger points of hazardous operation. The MC4700 includes individual beam indicators, adjustable mounting brackets, exact channel select, floating blanking, auxiliary outputs, restart interlocks, two digit display diagnostic, and a simple 3-box design. Designed for use in locations in which space is limited, the small size of the MicroSafe allows it to be integrated with the support framing used on many automated industrial machines.

The MegaSafe MG4600 series was introduced in 2001. A full featured product, the MG4600 Series is designed to meet the safeguarding requirements for robust applications, such as automotive manufacturing. The MG4600 is available in 20 millimeters, 30 millimeters and 50 millimeter resolution, provides protected heights from 435 millimeters to 2,086 millimeters depending on system resolution, and offers a 20 meter sensing range. Control reliable circuitry eliminates the need for a separate controller, and patented individual beam indicators simplify alignment. Additional features include field-replaceable safety relays and weld shield, floating blanking to block up to two beams anywhere in the zone, and exact channel select to permanently block selected beams where machine parts will obstruct a portion of the zone.

The PA4600 Series Perimeter Access Guard is a long range, multi-beam system used for guarding the perimeters of robotic cells and large automated machinery. The PA4600 has an operating range of up to 70 meters. The simple “two-box” design eliminates the need for a separate controller, saving the customer installation time and expense. The PA4600 product corresponds to the requirements of ANSI/RIA 15.06, a robot safeguarding standard used in the US, and other international standards. The PA4600 was introduced to our customers in 2003.

During 2003, we also introduced the new MP2100 Protective Light Curtain, designed to provide a reliable, low cost guarding solution for equipment where the safety assessment indicates a low risk of injury. The MP2100 was designed primarily for international markets, where this type of product has been used in a variety of low risk applications.

The FlexSafe is a segmented safety light curtain that offers greater flexibility and machine guarding for unusually shaped applications. Instead of a single transmitter and receiver, the FlexSafe is offered with two or more segments comprising each transmitter and receiver. The respective transmitter and receiver segments are connected with flexible cables to facilitate fitting to the machinery.

The DuoSafe controller allows the customer to configure two independent safety light curtains to achieve common or discrete outputs. The DuoSafe provides further application flexibility for customers when selecting their safeguarding solution.

Selected models of the safety light curtain products are certified by independent laboratories to comply with safety and electrical standards, including those standards required in the European Community. Products which pass the stringent European safety certifications carry the CE test mark.

b. Mechanical Safety Interlocks and Safety Relays. Safety interlock switches are utilized on hinged, sliding, or lift-off guards and barriers that are often installed with our safety light curtains. When the guard is opened, the power supply to the machine is disconnected. Safety relays are electromechanical devices which often serve as a safety interface between the mechanical safety interlocks and the machine's control system. The function and application of safety interlocks are complementary to our range of safety products. STI distributes these products under the STI brand by private label arrangements with several suppliers. STI has been distributing interlock switch products since 1993.

c. Safety Mats and Controllers. Our safety mats are designed for use in industrial environments where safety enhancements or zone detection is required. The mats are sensitive to foot or vehicular traffic. Safety mats are used with a mat controller, which is the interface between the safety mat and the control system of the guarded machine.

Our UM Series mat and safety mat controller were tested and certified by an independent test agency to an international safety mat standard. These products carry the European CE test mark. The UM Series and the associated controller was introduced to our sales channel during 2000.

To complement the safety mats, STI also manufactures several safety mat controllers, the MC3, MC4 and MC6. These products offer selection of either an industry standard DIN enclosure (MC3) or a rugged industrial style metal enclosure (MC4) with auto selection input voltages. The MC6 Safety Mat Controller offers enhanced diagnostics and is capable of providing up to six individual mat zones. All controllers are third party certified and CE marked to international standards for safety mat systems.

d. Safety Contact Strips. Safety contact strips are used in edges of guards, doors and gates at possible pinch, crushing or shear points. The contact strips are pressure sensitive devices and operate similar to safety mats, and use an appropriate controller. The system, comprised of the contact strips and controller are also third party certified to international standards and carry the CE mark.

e. Optical Profiling Scanners. In today's industrial environment, non-contact, on-the-move sensing is vital to control automated processes and improve industrial productivity. To meet this need, we have developed a line of optical profiling scanner products. These scanners provide non-contact sensing for a variety of customer applications.

We manufacture a family of high speed, microprocessor-based profiling scanners designed to provide an economical way to measure the physical size of various objects. The modular design of these scanners enables the user to select among various output and programming functions, including infrared beam spacings, size of the scanned area and single or multiple axes. Firmware is included with the product for a variety of scanning applications and may be simply customized to meet a customer's specific needs.

We also manufacture and sell the Vehicle Scanner Series of high speed, profiling scanners utilized in automated highway toll collection systems. These scanners are used for vehicle detection, separation and classification, providing imaging information to a host computer, which determines the appropriate toll to be charged in an automatic fare collection application. STI Vehicle Scanners have been selected or installed on a number of bridges and toll roads both in the United States and internationally. Domestic locations include the Triborough and Verrazano Narrows bridges in New York, a number of bridges in the San Francisco Bay Area, including the Golden Gate Bridge and the San Francisco–Oakland Bay Bridge, and toll roads in Pennsylvania, Colorado, Florida, Maine, New Jersey and Kansas. International locations include France, Belgium, Singapore and Brazil.

f. STI Machine Services Division. We acquired Dunn Sales, Inc. (“DSI”), a provider of safety and machine services, in June 2001. In 2003, we renamed this subsidiary as STI Machine Services Division (“MSD”). MSD is located in Anaheim, California, and provides safety services such as: safeguarding equipment installations, machine safety assessments, and the design and custom fabrication of guarding solutions. Furthermore, MSD specializes in machinery services including the repair, relocation, sales, installation and service of fabricating machinery. MSD serves customers in a variety of industries, including metal fabrication, aerospace, electronics, building materials, automotive and food processing.

g. Photoelectric and Fiberoptic Sensors. We manufacture and/or market a variety of photoelectric and fiberoptic sensors used for detecting the presence or absence of objects in a wide range of factory automation applications.

Fiberoptic sensors utilize flexible glass or plastic fiberoptic cable to traverse the light beam from the solid state light source to the receiving electronics. This cable is very small, and is resistant to high temperatures, corrosive chemicals or repeated flexing. Fiberoptic sensors are often used in confined spaces and in environments in which standard photoelectric sensors typically would not survive.

To cover this diversified industrial market, we market these products primarily to end-users and original equipment manufacturers through more than 575 worldwide distributor

locations. STI Safety Product Group distributors are primarily in two categories, Automation Safety Partners (“ASP”) and Automation Safety Distributors (“ASD”). We created the ASP program to meet the rising expectations of our customers and the demands required for STI to be a single source safety solution provider. In order to become an ASP, an organization must commit to a number of requirements, including an extensive training program for their STI product specialists, a newsletter program, demonstration equipment and safety seminars for their local customers. A smaller number of distributors that do not meet the requirements of the ASP program are classified as ASDs and have a reduced discount structure for the purchase of STI products.

## 2. Automation Products Group:

a. Level and Flow Sensors. We manufacture and market a variety of level sensing products to meet the diverse and demanding applications of our customers. To complement our product offering, we market a variety of level and flow sensing products imported from several manufacturers in Japan. The principal provider of these products is Nohken, a leading level control manufacturer in Japan. We are the US distributor of the Nohken products. These products provide point level detection of solids, liquids and solids/liquids, as well as contiguous measurement of continuous flow of solids and liquids, in a wide variety of environments.

b. Non-contact Ultrasonic Sensors and Controllers. We produce over 75 types of ultrasonic sensors and controller systems as well as specialty products. These products fall into two categories: sensor/controller systems, which are used for monitoring, displaying or controlling level in tanks or bins, open channel flow, tank volume, obstacle avoidance and product dimensioning; and self-contained sensor systems, in which all electronics are located within the sensor, requiring no separate controller or transmitting unit. These products are used for linear position measurements in industrial and level applications, as well as dimensioning and sorting, measurement of roll diameter, loop control, monitoring liquids and bulk solids and level gauging.

c. Pressure Transducers, Digital Pressure Gauges, Displacement and Velocity Transducers, and Pressure Comparators. These products are used in a variety of factory automation, aerospace, medical, semiconductor, oil and gas markets and applications. During 2003, we consolidated the engineering, manufacturing, administration and sales operations of these products into our facility in Logan Utah. A small assembly operation remains in Tulare, California and will be relocated to Logan at a later date.

d. Control Components, Power Monitoring and Defense Electronics. We manufacture and market a variety of sensors and relays for commercial and defense customers. Such products include custom magnetic components, current sensors, RPM sensors, voltage sensors, current monitors, time delay relays, flashers, phase sequence relays and indicators, DC to DC converters, and isolation transformers. We market and sell these products directly to end customers or specialty resellers.

We are qualified as a supplier of a variety of military-specified sensors and controls. Many of these products are selected for use on military and general aviation aircraft and ground support systems. Products are sold to original equipment manufacturers, government agencies and end users.

Our mission to provide tailored solutions for measurement applications is reflected in the structure, operations, and channels to market of our Automation Products Group. A traditional geography-based sales channel, utilizing independent representative sales organizations was established in 2003, for this business unit. The current market focus includes semiconductor manufacturing, aerospace industries, hydraulic equipment OEMs, petro-chemical, and water/waste-water management. In order to satisfy another important step in maximizing resource utilization in our Automation Products Group, we focus our product development efforts in custom and modified products for specific volume OEM customers. This is in sharp contrast to a more traditional, capital intensive effort to cover every possible product range.

### **Sources and availability of components**

We maintain an inventory of components and parts for our manufacturing activities. Although there are many sources for most of the components needed, we purchase some products, components and sub-assemblies from sole sources, which may be the only available supplier or may enable us to obtain pricing or supply efficiencies. In the event of supply interruptions from these vendors, we believe that we could obtain most sole source components from alternate suppliers; however, this would require us to transfer tooling or designs, or to redesign our products to facilitate use of alternate source components. We could incur delays by switching to an alternate source, which could have an adverse effect on our business, financial condition and results of operations.

We also derive revenue from the distribution of products from third party manufacturers, including revenues pursuant to our relationship with EJA Limited, a subsidiary of Rockwell International and Nohken (See Business – Our Products and Markets – Automation Products Group – Level and Flow Sensors), and others. In the event such arrangements are terminated or third party products otherwise become unavailable, our results of operations could be adversely affected.

### **Research and development**

In order to meet the changing needs of our customers, we engage in research and development both to introduce new products and to improve existing products. In addition, we modify products as necessary to meet original equipment manufacturers' requirements. At December 31, 2003, there were approximately 29 employees engaged in research and development activities. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Factors That May Affect Future Results - Technological Change and New Product Development."

In 2003, 2002, and 2001, we spent \$4,355,000, \$4,653,000, and \$5,429,000, respectively, on engineering, research and development. In addition to new products and enhancements to existing products, our research and development efforts are directed towards qualifying our light curtains, scanners and sensors for sale in foreign countries and qualifying products that we import for sale in the U.S. We anticipate that the level of research and development expenditures in 2004 to be consistent with 2003.

### **Patents and trademarks**

We hold nineteen US patents and nine US registered trademarks. In addition, we have been licensed by our parent company to use three patents for its products and eight US registered

trademarks, including the use of its logo "STI". Scientific Technology, Scientific Technologies, Datricon, STI, the STI logo, OptoSwitch, OptoData, OptoSafe and Fiberlens, are registered trademarks of our parent company. Aegis, BeamSafe, DuoSafe, FlexSafe, FastScan, SpectraData, PartScan, QuadSafe, MegaSafe, MicroSafe, MiniProtect, MiniSafe OptoFence, OptoShield, TouchStart, and ValuScan are trademarks of the Company. This Annual Report on Form 10-K also refers to trademarks and service marks of other companies and entities.

We cannot assure you that these patents or trademarks or other steps taken by us to protect our intellectual property will prove sufficient to prevent misappropriation of our technology. Because of the rapid rate of technology change in the electronics industry, we believe our success in the future depends on the quality of our products and services and the technical skills of our personnel to adapt to technological developments, rather than solely on our patents.

### **Competition**

The industry in which we operate is competitive and subject to rapid technological change. Many of our competitors are significantly larger and possess greater financial and other resources.

Our competitors include, among others, Banner Engineering, Cutler Hammer, Danaher Controls, Eaton Corporation, Honeywell, Keyence, Link Controls, Omron, Rockwell Automation and Sick Optic-Electronic, Inc. Competitors of the control components power monitoring and defense product lines include several of the above-mentioned firms and also Hi-G, Logitek, SCI Systems, Inc., Technitrol, and Xentek. Certain of our suppliers, including Rockwell/EJA, also compete with us. In addition, we face indirect competition from present and potential end users who from time to time evaluate the "make or buy" decision of whether to manufacture their own components or purchase them from outside sources.

Competition is based primarily upon product quality, performance and price. We believe that we generally compete favorably with respect to these factors. To maintain our competitive position, we will continue to devote substantial resources to the development of new products and improvements to current products. See "Business - Research and Development."

### **Foreign operations**

We have no foreign manufacturing operations. STI Scientific Technologies GmbH, a wholly owned German subsidiary, was established in 1995 as our European sales office. Our products are also sold in foreign countries by distributors and independent sales representatives. Foreign sales represented 12% of sales in 2003 and less than 10% of sales in each of 2002 and 2001. The Company's sales by geographic location of customers in 2003 were: North America – \$53,356,000, Europe - \$1,093,000 and Asia - \$1,045,000. Foreign sales represented less than 10% of sales in each of 2002 and 2001.

## **Customers**

No customer represented more than 10% of sales in 2003, 2002 or 2001. Aggregate sales to both government agencies and government contractors represented less than 5% of sales in 2003, 2002 and 2001.

## **Costs and effects of compliance with environmental laws**

Compliance with environmental protection laws or similar ordinances is not expected to have any material affect on our business.

## **Employees**

At December 31, 2003, we employed approximately 369 full time employees. Included in this total were the common manufacturing, support and administrative staff that we share with our parent and its other subsidiaries at the Dumbarton Circle facility in Fremont, California.

None of the employees are represented by unions, and there has never been a disruption of operations due to a labor dispute.

Many of our employees are skilled in technical and engineering disciplines and our future success will depend, in part, upon our ability to attract and retain such employees. We believe that relations with our employees are good.

## **Item 2. PROPERTIES**

We own no real estate and all of the following buildings are leased. Our manufacturing operations, corporate headquarters, administrative, engineering and sales offices are located in a 95,000 square foot facility in Fremont, California, a small portion is occupied by our parent. The facility is owned by an affiliate of our parent.

The Automation Products Group (APG) is located in a 25,000 square foot building in Logan, Utah. This facility is owned by our parent. APG also leases a 25,000 square foot facility in Tulare, California, of which 20% is currently utilized. The operations that were located in the unused portion of this building were consolidated to Logan, Utah in 2003. The remaining Tulare operations will be relocated in 2005, as the current lease expires.

STI Machine Services is located in an 8,585 square foot facility in Anaheim, California.

STI GmbH is located in a 2,500 square foot facility in Freiburg, Germany.

We are currently assessing our needs for additional space for our Logan, Utah operations, otherwise, we believe that our current facilities are suitable to meet our operating needs.

See Note 12 of Notes to Consolidated Financial Statements for information regarding lease commitments.

We maintain insurance policies for property, casualty, fire, business interruption, workers compensation, general liability and product liability. There can be no assurance that in the future, we will continue to be able to obtain such insurance on commercially and economically feasible terms. In the event we were to suffer a claim not covered by insurance or if insurance coverage is insufficient, such claim could have an adverse effect on our operations or financial condition.

### **Item 3. LEGAL PROCEEDINGS**

From time to time, we are subject to various legal proceedings that arise in the ordinary course of our business. Although we cannot predict the outcomes of these proceedings with certainty, our management does not believe that the disposition of these matters will have a material adverse effect on our financial position, results of operations or cash flows.

### **Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

## **PART II**

### **Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS**

#### **Market Information**

Our Common Stock is traded on the NASDAQ National Market under the symbol STIZ. The stock tables in most daily newspapers list our Common Stock under "SciTech".

#### **Price of Common Stock**

2003	High	Low	2002	High	Low
1st Quarter	\$5.99	\$3.36	1st Quarter	\$4.90	\$3.65
2nd Quarter	5.98	3.83	2nd Quarter	4.75	3.10
3rd Quarter	5.15	4.05	3rd Quarter	4.45	2.25
4th Quarter	5.00	4.01	4th Quarter	6.55	3.90

The closing sales price of our Common Stock on March 19, 2004 was \$5.50 per share.

#### **Holders**

There were 756 shareholders of record on March 19, 2004.

#### **Dividends**

In 2001, regular annual dividends of \$.0525 per share were paid on April 2 and July 5. No dividends were paid in 2002 or 2003.

#### **Equity Compensation Plan**

Please see Item 12 of this Annual Report on Form 10-K for disclosure relating to our equity compensation plans. Such information is incorporated by reference to our 2003 proxy statement.

## **Item 6. SELECTED FINANCIAL DATA**

### **i) FIVE YEAR CONSOLIDATED FINANCIAL DATA**

	Year Ended December 31,				
	(In thousands except per share data)				
<u>Statement of operations data</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
Net sales	\$55,494	\$51,207	\$49,053	\$60,146	\$49,925
Income (loss) from operations	497	744	(2,474)	8,745	6,834
Net income (loss)	428	472	(1,425)	5,631	4,505
Basic income (loss) per common share	\$ .04	\$ .05	\$ (.15)	\$ .58	\$ .47
Diluted income (loss) per common share	\$ .04	\$ .05	\$ (.15)	\$ .58	\$ .47

  

	December 31,				
<u>Balance sheet data</u>					
Cash and cash equivalents	\$ 2,312	\$ 2,620	\$ 1,033	\$ 4,048	\$ 3,362
Total assets	37,680	37,892	34,200	37,028	32,536
Shareholders' equity	30,288	29,750	29,234	31,591	27,849
Dividends declared per share	--	--	\$ .11	\$ .20	\$ .19

### **ii) QUARTERLY CONSOLIDATED FINANCIAL DATA (UNAUDITED)**

(In thousands, except per share data)

<b>2003</b>	First <u>Quarter</u>	Second <u>Quarter</u>	Third <u>Quarter</u>	Fourth <u>Quarter</u>
Sales	\$12,959	\$14,273	\$14,001	\$14,260
Gross profit	5,546	6,146	5,282	6,058
Net income (loss)	90	208	(246)	376
Basic net income (loss) per common share	\$ .01	\$ .02	\$ (.03)	\$ .04
Diluted net income (loss) per common share	\$ .01	\$ .02	\$ (.03)	\$ .04

  

<b>2002</b>	First <u>Quarter</u>	Second <u>Quarter</u>	Third <u>Quarter</u>	Fourth <u>Quarter</u>
Sales	\$ 11,229	\$12,829	\$13,034	\$14,115
Gross profit	4,854	5,606	5,783	5,964
Net income (loss)	(207)	143	348	188
Basic net income (loss) per common share	\$ (.02)	\$ .01	\$ .04	\$ .02
Diluted net income (loss) per common share	\$ (.02)	\$ .01	\$ .04	\$ .02

## **Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The discussion and analysis below contains trend analysis and other forward-looking statements including statements regarding anticipated future sales, margin and expense levels, future tax rates, future cash flow and working capital requirements. Actual results could differ materially from those projected in the forward looking statements as a result of the risk factors set forth under "Factors that May Affect Future Results" and elsewhere in this report. The following discussion should be read in conjunction with our consolidated financial statements and notes thereto. All references to years are to fiscal years unless otherwise noted.*

### **Results of Operations**

#### **Sales**

The Company is organized into two product groups - the Safety Products Group ("SPG") and the Automation Products Group ("APG"). Group sales for the years ended December 31, 2003, 2002 and 2001 were:

	<u>2003</u>	<u>%</u>	<u>2002</u>	<u>%</u>	<u>2001</u>	<u>%</u>
SPG	\$46,708	84%	\$43,493	85%	\$40,085	82%
APG	\$ 8,786	16%	\$ 7,714	15%	\$ 8,968	18%

Sales in 2003 increased 8% to \$55.5 million from \$51.2 million in 2002. Sales by SPG increased \$3.2 million or 7% from 2002 to 2003, as a result increases of 6% in shipments of safety light curtains, 11% in shipments of profiling scanner products, 4% in interlock and relay shipments and 8% in safety mat sales. In addition, SPG's Machine Services Division ("MSD") recorded a 30% increase in revenue. Sales by APG grew \$1.1 million or 14% due to increases of 27%, 8% and 5% in shipments of level products, control components and pressure products, respectively.

Sales in 2002 increased 4% to \$51.2 million from \$49.1 million in 2001. Sales by SPG increased 9% from 2001 to 2002. This was the result of increased unit sales at the Optical Sensor Division as well as the full year effect of sales by MSD, which was acquired in June 2001. Shipments of safety light curtains, profiling scanners and safety mats grew by 7%, 2%, and 3%, respectively, offsetting a 9% decline in sales of interlocks and relays. The full year effect of sales by MSD accounted for approximately one third of the 9% growth in sales by SPG. During 2002, APG continued to be negatively impacted by economic conditions in the semiconductor industry and as a result, reported a 14% decline in its sales, primarily in the pressure sensing product line.

The table below summarizes operating costs and expenses as a percentage of sales for the most recent three years.

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Sales	100%	100%	100%
Gross margin	42	43	40
Operating expenses:			
Selling, general and administrative	32	31	33

Research and development	8	9	11
Amortization of intangibles	1	1	1
Total operating expenses	41	41	45
Income (loss) from operations	1	2	(5)
Interest and other income, net	--	--	--
Income (loss) before taxes	1	2	(5)
Provision (benefit) for income taxes	--	1	(2)
Net income (loss)	1%	1%	(3)%

### **Gross profit**

2003 = \$23.0 million  
2002 = \$22.2 million  
2001 = \$19.7 million  
Increase in 2003 = 4%  
Increase in 2002 = 13%

Our gross margin was 42% of sales in 2003 compared to 43% of sales in 2002, as a result of a shift in the mix of products sold to those bearing a higher relative cost. Our gross profit in 2003 increased 4% over 2002, due to the increased sales. This trend was reflected in the results recorded by both SPG and APG. Our gross margin was 43% of sales in 2002 and 40% of sales in 2001 as we sold more higher margin products at the Safety Products Division. As a result of the higher level of shipments in 2002, our gross profit increased 13% over 2001.

### **Selling, general and administrative expenses**

2003 = \$17.5 million  
2002 = \$16.1 million  
2001 = \$16.1 million  
Increase in 2003 = 9%  
Change in 2002 = 0%

Selling general and administrative expenses increased \$1.4 million or 9% in 2003 compared to 2002. This was primarily the result of higher marketing and selling costs associated with the expanded revenue. In addition, APG recorded \$300,000 in expenses relating to the consolidation of the bulk of our Tulare, California operations into our Logan, Utah facility. This consolidation was essentially completed in 2003, with the exception of one small operation, which we expect to relocate in 2005.

During 2002, as a result of the cost reduction measures initiated in 2001 and continued in 2002, we were able to keep our 2002 selling, general and administrative expenses at 2001 levels in absolute dollars in spite of a 4% increase in sales. Selling, general and administrative expenses were 32% and 31% of sales in 2003 and 2002 compared to 33% of sales in 2001.

### **Research and development expenses**

2003 = \$4.4 million  
2002 = \$4.7 million  
2001 = \$5.4 million  
Decrease in 2003 = 6%  
Decrease in 2002 = 13%

Product creation, development and enhancement have always been and continue to be an important factor in our long-term success. Investments in this area enable us to serve the factory automation market with increasingly sophisticated sensors and manufacturing control products. As a result of the above mentioned cost reduction measures and a lowering of our reliance on outside contractors, we were able to reduce our research and development expenditures by 6% from 2002 to 2003 and 14% from 2001 to 2002. In 2003, 2002 and 2001, we introduced a number of new products and product enhancements. Consistent with our dedication to the development of new products, we anticipate that the level of research and development expenses will remain constant in 2004. To date, all product development costs have been expensed as incurred.

### **Income Taxes**

Our effective income tax rate was 38% in 2003 and 2002. As a result of the losses sustained in 2001, we recorded an income tax benefit of 38% of the loss for the year. We expect that our effective tax rate for 2004 will be reasonably consistent with 2003 and 2002. See Notes 1 and 5 of Notes to Consolidated Financial Statements.

### **Liquidity and Capital Resources**

Our working capital needs have been met through funds generated from operating activities. During 2003, operating funds were provided by net income adjusted for depreciation and amortization and increased accrued expenses. These operating funds were used to offset increases in accounts receivable, receivable from Parent and inventories, to purchase fixed assets and to pay down our capital lease obligation. Working capital amounted to \$17.5 million at December 31, 2003, a 5% increase from the \$16.7 million at December 31, 2002. Our bank line of credit of \$6.1 million was renewed in 2003 and extended to June 30, 2004. We have an option to convert up to \$1.0 million of the credit line into a five-year term note. Secured by qualified receivables, fixed assets and inventories, borrowings under this credit line bear interest at the bank's prime rate. At December 31, 2003, none of the line of credit had been utilized.

We made certain capital expenditures during 2003, primarily for production, quality assurance, research and development equipment, information systems and software. Consistent with our historical operations and our current plans for growth, we plan to make additional capital expenditures during 2004, primarily for production, quality assurance and research and development equipment. While we had no formal commitments at December 31, 2003, it is anticipated that capital expenditures in 2004 will be in excess of \$1.0 million, predicated on our profitability and cash resources.

We believe that cash flow from operations and available bank borrowings will be sufficient to meet anticipated working capital requirements through at least 2004. While we continue to evaluate financing alternatives from time to time, we have no current plans to raise additional outside capital. At December 31, 2003, future minimum payments under our leases due in the years 2004 and 2005 were approximately \$1,265,000 and \$1,083,000, and \$230,000 each for the years 2006 through 2008.

### **Relationship with Parent**

Intercompany transactions between us and our parent company include charges to our parent for management services provided by us, dividend payments to our parent and other cash transfers. Our parent files a consolidated tax return including our accounts. Our tax provision or benefit is calculated on a stand-alone basis. Our income taxes payable or receivable calculated on that basis are paid to or received from our parent.

### **Critical Accounting Policies**

#### **Revenue Recognition**

Revenue from product sales to customers is recognized upon shipment when shipped FOB our plant or upon receipt by the customer when shipped FOB destination, if a signed purchase order exists, the price is fixed or determinable, collection of the resulting receivable is considered reasonably assured and product returns can be reasonably estimated. Subsequent to the sale of the products, we have no obligation to provide any modification or customization, upgrades, enhancements or postcontract customer support. Upon revenue recognition, we provide for the estimated costs that may be incurred for product warranties. We estimate sales returns and warranty costs based on historical experience and the best information we have at the time we report our financial statements. Actual results could differ from these estimates.

Installation and engineering service revenue is recognized when services are rendered, or when an identifiable portion of the contract is completed, no significant post-delivery obligations exist and collection of the resulting receivable is considered reasonably assured.

#### **Inventories**

We value our inventory at the lower of the actual cost to purchase and/or manufacture the inventory or the current estimated market value of the inventory. We regularly review inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our historical consumption and our estimated forecast of product demand and production requirements. Demand for our products can fluctuate significantly. In addition, our industry is characterized by technological change, new product development, and product obsolescence that could result in an increase in the amount of obsolete inventory quantities on hand. Our estimates of future product demand may differ from actual results, in which case we may adjust the provision required for excess and obsolete inventory. In the future, if our inventory is determined to be overvalued, we would be required to recognize such costs in our cost of goods sold at the time of such determination. Likewise, if our inventory is determined to be undervalued, we may have over-reported our costs of goods sold in previous periods and would be required to recognize such additional operating income at the time of sale. Therefore, although we make every effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventory and our reported operating results.

## **Accounts Receivable**

We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and the customer's current credit worthiness, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that we have identified. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates that we had in the past. A significant change in the liquidity or financial position of any one of our customers could have an adverse impact on the collectability of our accounts receivable and our future operating results.

## **Valuation of Long-Lived Assets**

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We review the recoverability of our long-lived assets, such as fixed assets, goodwill, intangible assets and investments, when events or changes in circumstances indicate that the carrying amount of the asset or asset group may not be recoverable. The assessment of possible impairment is based on our ability to recover the carrying value of the asset or asset group from the expected future pre-tax cash flows (undiscounted and without interest charges) of the related operations. If these cash flows are less than the carrying value of such asset, an impairment loss is recognized for the difference between the estimated fair value and carrying value. The measurement of impairment requires management to estimate future cash flows and the fair value of long-term assets.

## **Factors that May Affect Future Results**

Because of the variety of factors and uncertainties affecting our operating results, past financial performance and historical trends may not be a reliable indicator of future performance. These factors, as well as other factors affecting our operating performance, may result in significant volatility in our common stock price. Among the factors which could affect our future business, financial condition or operating results are the following:

### **Our operating results may fluctuate.**

We have experienced fluctuations in annual and quarterly operating results and anticipate that these fluctuations will continue. These fluctuations are caused by a number of factors, including the level and timing of customer orders, fluctuations in complementary third party products with which our products are sold, the mix of products sold and the timing of operating expenditures. Our operating results are also negatively impacted by generally adverse economic conditions throughout the high technology sector. In particular, our pressure products continue to experience low sales volume due to the recent market conditions in the semiconductor industry.

### **The seasonality inherent in our business could cause our operating results to fluctuate.**

The industrial manufacturing equipment industry in which we compete has historically been subject to seasonality. This is also true with respect to European markets in which we compete where business activity declines due to vacations taken in the summer months. This seasonality, combined with other factors such as the variability in our operating results

described above, renders quarter-to-quarter comparisons of our results of operations unreliable as indicia of our overall performance.

**The market for our products is highly competitive.**

The market for industrial sensors is highly competitive. Many competitors have substantially greater name recognition and technical, marketing and financial resources than we have. Competitive pressures could reduce market acceptance of our products and result in price reductions, decreased revenues and increases in expenses.

**Our business could suffer if we do not respond to technological change and new product development demands of our customers.**

The market for our products is characterized by changing technology, evolving industry standards, changes in customer needs and new product introductions. Our future success will depend on our ability to respond to emerging industry standards, enhance current products, develop new products, and achieve market acceptance of those products, all on a timely and cost-effective basis. The introduction of new products also requires that we manage the transition from older products in order to minimize disruption of customer orders, avoid excessive levels of older product inventories and ensure that adequate supplies of new products can be delivered to meet customer demands.

**Our sales are dependent on independent distributors.**

A majority of our sales are through third party distributors, system integrators and original equipment manufacturers. These resellers are not required to offer our products exclusively. We cannot assure you that a reseller will continue to offer our products. In addition many of our resellers are privately owned firms which may not be well capitalized, as was demonstrated by the failure of two of our distributors during 2001. If our ability to sell products through these third parties is impaired, our results of operations would likely suffer.

**Our international sales are subject to risks.**

Our international sales may be disrupted by currency fluctuations or other events beyond our control, including political or regulatory changes. If our international sales were disrupted for any reason, our revenue levels would decline.

**Our business could suffer if we are unable to protect and enforce our intellectual property rights.**

We rely on a combination of patent, trademark, trade secret laws and contractual restrictions to establish and protect proprietary rights in our products and services. There can be no assurance that our patents, trademarks, or contractual arrangements or other steps taken by us to protect our intellectual property will prove sufficient to prevent misappropriation of our technology or defer independent third party development of similar technologies. Moreover, there can be no assurance that the technology licenses granted to us from our parent company will continue to be available. The loss of any of our proprietary technology could require us to obtain technology of lower quality or performance standards or at greater cost, which could materially adversely affect our business, results of operations and financial condition. Also, competitors may develop their own intellectual property or technologies, obtain their own patents, or challenge the validity of, or be able to design

around, our patents. The laws of certain foreign countries may not protect our products, services or intellectual property rights to the same extent as do the laws of the United States.

We may initiate claims or litigation against other third parties for infringement of proprietary rights or to establish the validity of proprietary rights. Similarly, our competitors may initiate claims or litigation against us alleging infringement of their proprietary rights or improper use of their intellectual property. Litigation relating to intellectual property to which we may become a party is subject to numerous risks and uncertainties, including the risk of counterclaims or other litigation against us, and we may not be successful in any such litigation.

**Our operations have been and may continue to be negatively impacted by uncertain global economic and political conditions**

Our business may suffer as a result of general economic and political conditions in the U.S. and abroad. In 2002 and 2001, there was a rapid and severe downturn in the U.S. market and global economy. Whether that trend will continue is uncertain. This uncertainty has been compounded by recent terrorist activity, such as the attacks in the U.S. on September 11, 2001, and the recent military activity in Afghanistan, Iraq and the Middle East. Additional terrorist acts or acts of war could cause damage or disruption to us or to our suppliers and our customers. Fears of global recession, war, and terrorism may continue to have seriously detrimental effects on the U.S. and global economies. Such conditions could further dampen consumer confidence and cause our customers to slow or cease spending on our products. If these events continue, our operations may be negatively impacted.

**We are dependent upon suppliers and outsourced manufacturing, several of which are located outside of the U.S. Disruption of our access to these supplies and services, or problems with the quality of supplies or services, could prevent us from filling customer orders and harm our business.**

The principal components of our products are purchased from outside vendors. We generally buy components under purchase orders, do not have long-term agreements with our suppliers, and we generally do not maintain large inventories of components. Any termination of, or significant disruption of, our relationships with the suppliers of our product components may prevent us from filling customer orders in a timely manner which could result in customer dissatisfaction and lost sales.

We rely on third party manufacturers for subassembly of products and for final assembly, quality assurance, and testing of some of our products. These outsourcing arrangements and any future outsourcing arrangements involve numerous risks, including reduced control over product quality, delivery schedules, manufacturing yields, and costs.

**Our ability to develop and market our products is dependent upon our retention of certain executive officers and other key personnel.**

We are greatly dependent on the ability to retain key management and technical personnel, and our future success is highly dependent upon the personal efforts of our management and technical personnel. The loss of services of any one of them could have a material adverse effect on our business, financial condition, and results of operations. Our success will also be dependent in part upon our ability to attract, retain, and motivate highly skilled employees. We may need to offer additional compensation or incentives to attract and retain these and other employees.

**If we are unable to successfully develop our international sales efforts, our results of operations may suffer.**

We have to develop, integrate, and expand our international distribution networks in an effort to increase international sales of our products. We may not be successful in developing or expanding the international distribution network or in marketing and selling products in foreign markets. If the revenues generated by our international sales are not adequate to recover the expense of establishing, expanding, and maintaining an international distribution network, our business, financial condition, and results of operations could be materially adversely affected. If international sales become a more significant component of net sales, our business could become more vulnerable to the risks inherent in doing business internationally, including:

- Difficulties in managing foreign resellers;
- Longer payment cycles and problems in collecting accounts receivable;
- The effects of seasonal customer demand;
- Changes in regulatory requirements;
- Difficulties in meeting the requirements of different international product regulations;
- Risks relating to intellectual property rights;
- Increased expenses due to efforts to localize our product offerings;
- Export restrictions, tariffs and other trade barriers;
- Fluctuations in currency exchange rates; and
- Potentially adverse tax consequences and political instability.

The existence or occurrence of any one of these factors could have a material adverse effect on our business, financial condition, and results of operations.

**Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

The market risk inherent in our investments represents the potential loss arising from adverse changes in interest rates. We are exposed to market risk in the area of interest rate changes impacting the fair value of our investment securities. Our policy is to invest primarily in money market accounts and short-term investments held at financial institutions. We do not have any derivative instruments in our investment portfolio. Due to their highly liquid nature, our investments are subject to minimal credit and market risk.

**Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.**

(a) The following documents are filed as a part of this Report:

	<b><u>Page</u></b>
(1) Financial Statements	
Report of Independent Auditors	21
Consolidated Balance Sheet - December 31, 2003 and 2002	22
Consolidated Statement of Operations - Years ended December 31, 2003, 2002 and 2001	23
Consolidated Statement of Cash Flows - Years ended December 31, 2003, 2002 and 2001	24
Consolidated Statement of Shareholders' Equity - Years ended December 31, 2003, 2002 and 2001	25
Notes to Consolidated Financial Statements	26

(2) Financial Statement Schedules

Financial Statement Schedules have been omitted because they are not required or applicable, or the information required to be set forth therein is included in the Financial Statements or notes thereto.

## **REPORT OF INDEPENDENT AUDITORS**

To the Board of Directors and  
Shareholders of Scientific Technologies Incorporated

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of operations, of cash flows and of shareholders' equity present fairly, in all material respects, the financial position of Scientific Technologies Incorporated (a subsidiary of Scientific Technology Incorporated) and its subsidiaries at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP  
San Jose, California  
March 15, 2004

**Scientific Technologies Incorporated**

**Consolidated Balance Sheet**

(In thousands, except per share data)

	December 31,	
	<u>2003</u>	<u>2002</u>
<u>Assets</u>		
Current assets:		
Cash and cash equivalents	\$ 2,312	\$ 2,620
Accounts receivable, net	8,139	7,636
Receivable from Parent	838	384
Inventories	9,281	8,719
Deferred income taxes	2,015	2,380
Prepaid expenses and other assets	<u>1,034</u>	<u>835</u>
Total current assets	23,619	22,574
 Property and equipment, net	 3,740	 3,725
Goodwill and other intangible assets, net	<u>10,321</u>	<u>11,593</u>
Total assets	<u>\$37,680</u>	<u>\$37,892</u>
 <u>Liabilities and Shareholders' Equity</u>		
Current liabilities:		
Accounts payable	\$ 2,758	\$ 2,942
Accrued expenses	3,267	2,836
Current portion of capital lease with Parent	<u>68</u>	<u>60</u>
Total current liabilities	6,093	5,838
 Capital lease with Parent	 164	 240
Deferred income taxes	<u>1,134</u>	<u>2,064</u>
Total liabilities	<u>7,391</u>	<u>8,142</u>
 Commitments and contingencies (Note 12)		
 Shareholders' equity:		
Common stock; \$.001 par value; 100,000		
shares authorized; 9,711 and 9,687		
shares issued and outstanding	10	10
Capital in excess of par value	5,792	5,681
Retained earnings	<u>24,487</u>	<u>24,059</u>
Total shareholders' equity	<u>30,289</u>	<u>29,750</u>
Total liabilities and shareholders' equity	<u>\$37,680</u>	<u>\$37,982</u>

The accompanying notes are an integral part of these financial statements

**Scientific Technologies Incorporated**  
**Consolidated Statement of Operations**  
(In thousands, except per share data)

	<u>Year Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Sales	\$55,494	\$51,207	\$49,053
Cost of goods sold	<u>32,462</u>	<u>29,000</u>	<u>29,329</u>
Gross profit	<u>23,032</u>	<u>22,207</u>	<u>19,724</u>
Operating expenses:			
Selling, general and administrative	17,504	16,110	16,111
Research and development	4,355	4,653	5,429
Amortization of acquired intangibles	<u>676</u>	<u>700</u>	<u>658</u>
Total operating expenses	<u>22,535</u>	<u>21,463</u>	<u>22,198</u>
Income (loss) from operations	497	744	(2,474)
Interest and other income, net	<u>193</u>	<u>17</u>	<u>176</u>
Income (loss) before income taxes	690	761	(2,298)
Provision (benefit) for income taxes	<u>262</u>	<u>289</u>	<u>(873)</u>
Net income (loss)	\$ <u>428</u>	\$ <u>472</u>	\$ <u>(1,425)</u>
Basic and diluted net income (loss) per share	\$ <u>.04</u>	\$ <u>.05</u>	\$ <u>(.15)</u>
Shares used to compute net income (loss) per share	<u>9,734</u>	<u>9,698</u>	<u>9,659</u>

The accompanying notes are an integral part of these financial statements.

**Scientific Technologies Incorporated**  
**Consolidated Statement of Cash Flows**  
(In thousands)

	<u>Year Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Cash flows from operating activities:			
Net income (loss)	\$ 428	\$ 472	\$(1,425)
Adjustments to reconcile net income (loss) to cash provided by operating activities:			
Depreciation and amortization	2,692	2,631	2,266
Changes in assets and liabilities:			
Accounts receivable, net	(503)	(1,182)	2,727
Receivable from Parent	(454)	(384)	--
Inventories	(562)	406	369
Prepaid expense and other assets	(199)	(254)	(170)
Accounts payable	(184)	1,056	(1,020)
Deferred income taxes	(565)	(167)	(209)
Accrued expenses	<u>431</u>	<u>188</u>	<u>(25)</u>
Cash flows provided by operating activities	<u>1,084</u>	<u>2,766</u>	<u>2,513</u>
Cash flows from investing activities:			
Purchases of property and equipment	(1,435)	(1,223)	(1,010)
Acquisition of Dunn Sales	--	--	(3,992)
Sale of short-term investments	<u>--</u>	<u>--</u>	<u>406</u>
Cash flows used in investing activities	<u>(1,435)</u>	<u>(1,223)</u>	<u>(4,596)</u>
Cash flows from financing activities:			
Issuance of common stock, net	111	44	84
Payment of capital lease obligation	(68)		
Dividends	<u>--</u>	<u>--</u>	<u>(1,016)</u>
Cash flows provided by (used in) financing activities	<u>43</u>	<u>44</u>	<u>(932)</u>
Change in cash and cash equivalents	(308)	1,587	(3,015)
Cash and cash equivalents at beginning of year	<u>2,620</u>	<u>1,033</u>	<u>4,048</u>
Cash and cash equivalents at end of year	<u>\$ 2,312</u>	<u>\$ 2,620</u>	<u>\$ 1,033</u>
Supplemental disclosure of cash flow information:			
Cash paid to (received from) Parent for income taxes	<u>\$ 262</u>	<u>\$ 289</u>	<u>\$ (873)</u>
Supplemental disclosure of non-cash activities:			
Capital lease with Parent	<u>\$ 232</u>	<u>\$ 300</u>	<u>\$ --</u>
Deferred tax liability related to acquisition of Dunn Sales	<u>\$ --</u>	<u>\$ 1,500</u>	<u>\$ --</u>

The accompanying notes are an integral part of these financial statements.

**Scientific Technologies Incorporated**  
**Consolidated Statement of Shareholders' Equity**  
(In thousands)

	<u>Common Stock</u>				
			Capital In Excess Of par Value	Retained Earnings	Total
	<u>Shares</u>	<u>Par Value</u>	<u>Value</u>	<u>Value</u>	<u>Value</u>
Balances at December 31, 2000	9,650	\$10	\$5,553	\$26,028	\$31,591
Issuance of common stock	33	-	116	-	116
Repurchase of common stock	(7)	-	(32)	-	(32)
Net loss for the year	-	-	-	(1,425)	(1,425)
Dividends paid	-	-	-	(1,016)	(1,016)
Balances at December 31, 2001	9,676	10	5,637	23,587	29,234
Issuance of common stock	22	-	69	-	69
Repurchase of common stock	(11)	-	(25)	-	(25)
Net income for the year	-	-	-	472	472
Balances at December 31, 2002	9,687	10	5,681	24,059	29,750
Issuance of common stock	24	-	111	-	111
Net income for the year	-	-	-	428	428
Balances at December 31, 2003	<u>9,711</u>	<u>\$10</u>	<u>\$5,792</u>	<u>\$24,487</u>	<u>\$30,289</u>

The accompanying notes are an integral part of these financial statements.

**Scientific Technologies Incorporated**  
**Notes to Consolidated Financial Statements**

**NOTE 1-THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**The Company**

Scientific Technologies Incorporated (the "Company") develops, manufactures and markets safety light curtains, industrial sensors, optical profilers, microcomputers and power monitoring devices for factory automation applications. In addition, the Company provides safeguarding equipment installation, rebuilding, repair and maintenance of fabricating machinery. A majority of the Company's outstanding common stock is held by Scientific Technology Incorporated, a California corporation (the "Parent").

The Company operates in two business segments - the development, manufacture and marketing of industrial safety products and the development, manufacture and marketing of industrial automation products. The Company operates in an industry characterized by significant competition.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates.

**Basis of Presentation**

The consolidated financial statements include the accounts of the Company and its subsidiaries after elimination of all significant intercompany accounts and transactions.

**Cash and Cash Equivalents and Short-Term Investments**

The Company invests primarily in money market accounts held at financial institutions and considers all highly liquid investments with a maturity of less than 90 days when purchased to be cash equivalents. Accordingly, these investments are subject to minimal credit and market risk.

Short-term investments consist of highly liquid investments, which mature in less than one year and are classified as "held-to-maturity." Interest income is accrued as earned.

**Inventories**

Inventories are stated at the lower of cost (first-in, first-out) or market.

**Property and Equipment**

Property and equipment are recorded at cost less accumulated depreciation and amortization. Depreciation is provided using the straight-line method over the estimated useful lives, which range from three to ten years. Leasehold improvements are amortized over the shorter of the term of the lease or the estimated life of the improvements.

**Goodwill and Other Intangible Assets**

Intangible assets include tradenames, customer relationships, product lines, technologies and a covenant not to compete acquired as part of the acquisitions of Dunn Sales, Inc., PSI-Tronix, Inc. and Lundahl Instruments, Inc. Intangible assets are generally amortized on a straight-line basis over a period of two to fifteen years. Goodwill is not amortized and is subject to impairment testing at the reporting unit level at least annually and more frequently upon the occurrence of certain events. A reporting unit is the same level as or one level below an operating segment.

**Long-Lived Assets**

The Company periodically evaluates the recoverability of its long-lived assets based upon the expected undiscounted cash flows attributable to such assets, and recognizes impairment from the carrying value of long-lived assets, if any, based on the fair value of such assets. No losses from impairment have been recognized for any of the periods presented.

**Fair Value of Financial Instruments**

The Company measures its financial assets and liabilities in accordance with generally accepted accounting principles. For certain of the Company's financial instruments, including cash, cash equivalents, short-term investments, trade accounts receivable, accounts payable and accrued expenses, the carrying amounts approximate fair value due to the short maturities.

**Revenue Recognition**

Revenue from product sales to customers is recognized upon shipment when shipped FOB shipping point or upon receipt by the customer when shipped FOB destination, if a signed purchase order exists, the price is fixed or determinable, collection of the resulting receivable is considered reasonably assured and product returns can be reasonably estimated. Subsequent to the sale of the products, we have no obligation to provide any modification or customization, upgrades, enhancements or postcontract customer support. Upon revenue recognition, we provide for the estimated costs that may be incurred for product warranties. We estimate sales returns and warranty costs based on historical experience and the best information we have at the time we report our financial statements. Actual results could differ from these estimates.

Installation and engineering service revenue is recognized when services are rendered, or when an identifiable portion of the contract is completed, no significant post-delivery obligations exist and collection of the resulting receivable is considered reasonably assured.

**Shipping and Handling**

All amounts billed to a customer in a sale transaction related to shipping and handling, if any, represent revenues earned for the goods provided and are classified as revenue. Costs incurred for shipping and handling are included in cost of sales.

**Research and Development**

Research and development costs are expensed as incurred.

**Advertising Costs**

Advertising costs are recorded as expenses when incurred. Advertising costs for the years ended December 31, 2003, 2002 and 2001 were \$548,000, \$590,000 and \$609,000.

### Stock-based compensation

The Company accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, or APB No. 25, "Accounting for Stock Issued to Employees." Under APB No. 25, compensation cost is measured as the excess, if any, of the quoted market price of the Company's stock at the date of grant over the exercise price of the option granted. Compensation cost for stock options, if any, is recognized ratably over the vesting period. The Company provides additional pro forma disclosures as required under Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation" and SFAS No. 148, "Accounting for Stock-Based Compensation, Transition and Disclosure".

SFAS No. 148, issued in December 2003 amends SFAS No. 123 in December 2003 to require that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. The following table sets forth the effect on the Company's net income (loss) and net income (loss) per share as if the Company had recorded compensation costs based on the estimated grant date fair value as defined by SFAS No. 123 for all granted stock-based awards (in thousands, except per share amounts).

	<b>Years Ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Net income (loss), as reported	\$ 428	\$ 472	\$(1,425)
Add: Stock-based employee compensation expense included in reported net income (loss)	-	-	-
Deduct: Stock-based employee compensation expense determined under fair value based method for all awards	<u>90</u>	<u>81</u>	<u>205</u>
Pro forma net income (loss)	<u>\$ 338</u>	<u>\$ 391</u>	<u>\$(1,630)</u>
Net income (loss) per share - basic and diluted:			
As reported	<u>\$ 0.04</u>	<u>\$ 0.05</u>	<u>\$( 0.15)</u>
Pro forma	<u>\$ 0.03</u>	<u>\$ 0.04</u>	<u>\$( 0.17)</u>

### Income Taxes

Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. The Company is included in the consolidated tax return of the Parent, but provides for income taxes on a separate return basis pursuant to a tax sharing arrangement, which limits the Company's tax liability to the amount payable to the Parent. Income taxes payable are recorded as a reduction to the receivable from Parent account or as an increase to the payable to Parent account.

### Comprehensive Income

Comprehensive income is defined to include all changes in shareholders' equity during a period from non-owner sources. There were no significant differences between the Company's net income (loss) and its total comprehensive income (loss) for any of the periods presented.

### Reclassifications

The Company has reclassified certain prior years' information to conform to the current year's financial statements.

### **Recent Accounting Pronouncements**

In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 46, or FIN 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after December 15, 2003. The Company believes that the adoption of this standard will not have material impact on its financial position, results of operations or cash flows.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies financial accounting and reporting of derivative instruments and hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 149 amends SFAS No. 133 for decisions made: (a) as part of the Derivatives Implementation Group process that require amendment to SFAS No. 133; (b) in connection with other FASB projects dealing with financial instruments; and (c) in connection with the implementation issues raised related to the application of the definition of a derivative. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for designated hedging relationships after June 30, 2003. The Company adopted SFAS No. 149 during 2003. The adoption of SFAS No. 149 did not have a material impact on the Company's financial position, results of operations or cash flows.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." The Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and further requires that an issuer classify as a liability (or an asset in some circumstances) financial instruments that fall within its scope because that financial instrument embodies an obligation of the issuer. Many of these instruments were previously classified as equity. The statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company adopted SFAS No. 150 during 2003. The adoption of this standard did not have a material impact on the Company's financial position, results of operations or cash flows.

### **NOTE 2 - RELATED PARTY TRANSACTIONS**

In 2003, the Company provided certain management services to the Parent. Costs of these services were allocated to the Parent based upon the amount of time employees spent providing these services. The amount charged to the Parent for 2003 was \$353,000. In 2002 and 2001, the Parent provided certain management, marketing and sales services to the Company. The costs of these services were allocated to the Company based on the percentage of the Company's sales to total sales of the Parent and its subsidiaries. The amounts allocated to the Company for 2002 and 2001 were \$806,000, and \$1,005,000, respectively.

The Company leases a 95,000 square foot facility owned by an affiliate of the Parent. The Company also leases another 25,000 square feet in another facility owned by the Parent. The lease terms are for ten years. Overhead costs are allocated primarily on the basis of square footage utilized.

The Company utilizes a receivable from/payable to Parent account to record activity including cash received, cash disbursed and amounts owed to and receivable from the Parent for allocated charges and dividends. The net effect of transactions with the Parent resulted in a receivable from Parent of \$838,000 at December 31, 2003 and \$384,000 at December 31, 2002. In addition, the Company is party to a capital lease of \$232,000 at December 31, 2003 under which the Parent is the lessor. At December 31, 2003, future minimum payments under this lease due in the years 2004 through 2006 were approximately \$68,000 each and \$28,000 in 2007.

### NOTE 3 - ACQUISITION

On June 8, 2001, the Company acquired all of the outstanding common stock of Dunn Sales, Inc. ("DSI"), for a cash payment of \$3,992,000. DSI is a leading provider of safeguarding equipment installation, rebuilding, repair and maintenance of fabricating machinery. The transaction was accounted for as a purchase and accordingly, the results of DSI operations are included in the Company's financial statements from the date of acquisition. In 2002, based on a reassessment of deferred tax liabilities related to the acquisition, \$1,500,000 was recorded to deferred tax liabilities and goodwill. The total purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed based on their respective fair values on the date of acquisition as follows (in thousands):

		Amortization period
Working capital	\$ 140	
Equipment	96	
Technology	1,985	15 years
Customer relationships	1,061	7
Tradename	<u>710</u>	5
	3,992	
Goodwill/deferred tax liability	<u>1,500</u>	
	<u>\$5,492</u>	

### NOTE 4 - BALANCE SHEET DATA

	December 31,	
	2003	2002
	(In thousands)	
<b>Accounts receivable:</b>		
Accounts receivable	\$ 8,642	\$ 8,181
Less: allowance for doubtful accounts	<u>(503)</u>	<u>(545)</u>
	<u>\$ 8,139</u>	<u>\$ 7,636</u>

	December 31,	
	2003	2002
<b>Allowance for doubtful accounts:</b>		
Balance at beginning of year	\$ 545	\$ 661
Addition	80	409
Utilized	<u>(122)</u>	<u>(525)</u>
Balance at end of year	<u>\$ 503</u>	<u>\$ 545</u>
<b>Inventories:</b>		
Finished goods	\$ 2,453	\$ 2,159
Work in process	1,225	1,043
Subassemblies	911	1,016
Raw materials	<u>4,692</u>	<u>4,501</u>
	<u>\$ 9,281</u>	<u>\$ 8,719</u>
<b>Property and equipment:</b>		
Equipment	\$10,979	\$ 9,995
Furniture and fixtures	1,923	1,686
Leasehold improvements	<u>737</u>	<u>523</u>
	13,639	12,204
Less: accumulated depreciation and amortization	<u>(9,899)</u>	<u>(8,479)</u>
	<u>\$ 3,740</u>	<u>\$ 3,725</u>
<b>Accrued expenses:</b>		
Accrued compensation	\$ 1,797	\$ 1,610
Accrued commissions	192	194
Warranty reserve	221	241
Accrued income tax	227	227
Stock rotation reserve	231	105
Price allowance reserve	154	70
Other	<u>445</u>	<u>389</u>
	<u>\$ 3,267</u>	<u>\$ 2,836</u>

**Goodwill and other intangible assets:**

		December 31, 2003		December 31, 2002	
		Gross		Gross	
	Life (Years)	Carrying Amount	Accumulated Amortization	Carrying Amount	Accumulated Amortization
Technology	15	\$ 7,146	(1,730)	\$ 7,146	(1,252)
Customer relationships	7	3,476	(1,686)	3,476	(1,152)
Tradename	5	710	(296)	710	(156)
Product lines	12	1,596	(395)	1,596	(275)
Covenant not to compete	2	<u>50</u>	<u>(50)</u>	<u>50</u>	<u>(50)</u>
Total amortized intangible assets		12,978	<u>\$ (4,157)</u>	12,978	<u>\$ (2,885)</u>
Goodwill		<u>1,500</u>		<u>1,500</u>	
Total		<u>\$14,478</u>		<u>\$14,478</u>	

The Company incurred amortization expense of \$1,272,000 and \$1,296,000 in 2003 and 2002, respectively, of which \$596,000 and \$290,000 were included in cost of goods sold. The

Company will incur amortization expense of approximately \$1,271,000 in 2004 and 2005, \$1,204,000 in 2006, \$827,000 in 2007 and \$676,000 in 2008.

#### Debt:

The Company has a \$6,100,000 line of credit with a bank, of which no amount was outstanding at December 31, 2003 or 2002. The line bears interest at the bank's prime rate (4.00% at December 31, 2003), is secured by accounts receivable, inventories and fixed assets, and expires on June 30, 2004. The Company's Bank line of credit as amended, contains covenants which require the Company to meet specific financial tests. The financial tests for 2003 were as follows: (1) a requirement of profitability on an annual basis and (2) a minimum tangible net worth requirement of \$16,500,000. At December 31, 2003, the Company was in compliance with the covenants.

#### NOTE 5 - INCOME TAXES

The provision (benefit) for income taxes was as follows:

	Year Ended December 31		
	2003	2002	2001
	(In thousands)		
Current tax expense (benefit)			
Federal	\$ 134	\$ 451	\$(637)
State	<u>5</u>	<u>8</u>	<u>(27)</u>
	<u>139</u>	<u>459</u>	<u>(664)</u>
Deferred tax expense (benefit)			
Federal	157	(36)	(209)
State	<u>(34)</u>	<u>(134)</u>	<u>--</u>
	<u>123</u>	<u>(170)</u>	<u>(209)</u>
Total provision for income taxes	<u>\$ 262</u>	<u>\$ 289</u>	<u>\$(873)</u>

The provision (benefit) for income taxes differs from the amount of tax determined by applying the applicable federal statutory income tax rate to pretax income as a result of the following differences:

	2003	2002	2001
Statutory U.S. tax rate	34%	34%	(34)%
State income taxes, net of federal benefit	6	6	(1)
Research and development and other credits	(24)	(27)	(7)
Nondeductible expenses	<u>22</u>	<u>25</u>	<u>4</u>
Effective tax rate	<u>38%</u>	<u>38%</u>	<u>(38)%</u>

	December 31,	
	2003	2002
Deferred tax assets (liabilities) consist of the following:	(In thousands)	
Short-term deferred tax asset		
Inventory reserve	\$ 784	\$ 964
Other reserves and accruals	808	739
Net operating loss	50	35
Depreciation	165	--
Research & development tax credit and other	<u>208</u>	<u>642</u>
Gross deferred tax assets	<u>2,015</u>	<u>2,380</u>

Long-term deferred tax liability

Depreciation and amortization	--	(734)
Acquired intangible assets	(1,097)	(1,330)
Other	<u>(37)</u>	<u>--</u>
Gross deferred tax liability	<u>(1,134)</u>	<u>(2,064)</u>
Net deferred tax assets	\$ <u>881</u>	\$ <u>316</u>

## NOTE 6 - INCOME (LOSS) PER SHARE

A reconciliation of the numerators and denominators of the basic and diluted income (loss) per common share computations is provided below.

	(In Thousands)		(Per Share)
	Income	Shares	Amount
2003			
Basic earnings per share calculation	\$ 428	9,711	\$.04
Effect of dilutive securities			
stock options	<u>-</u>	<u>23</u>	<u>-</u>
Diluted earnings per share calculation	\$ <u>428</u>	<u>9,734</u>	\$ <u>.04</u>
2002			
Basic earnings per share calculation	\$ 472	9,683	\$.05
Effect of dilutive securities			
stock options	<u>-</u>	<u>15</u>	<u>-</u>
Diluted earnings per share calculation	\$ <u>472</u>	<u>9,698</u>	\$ <u>.05</u>
2001			
Basic earnings per share calculation	\$(1,425)	9,659	\$(.15)
Effect of dilutive securities			
stock options	<u>-</u>	<u>-</u>	<u>-</u>
Diluted earnings per share calculation	\$ <u>(1,425)</u>	<u>9,659</u>	\$ <u>(.15)</u>

The number of common stock equivalents excluded from the earnings per share calculation because they would be antidilutive total to 444,000 in 2003, 523,000 in 2002 and 461,000 in 2001.

## NOTE 7 - DIVIDENDS

During 2003 and 2002, the Company paid no dividends. During 2001, the Company paid quarterly dividends of \$.0525 per share for the first two quarters of the year on April 3 and July 5.

## NOTE 8 - STOCK OPTION PLAN AND EMPLOYEE STOCK PURCHASE PLAN

### Stock Option Plan

The 1997 Stock Option Plan (the "Plan") provides for the granting of stock options to employees and consultants of the Company. Options granted under the Plan may be either incentive stock options or nonqualified stock options. Incentive stock options ("ISO") may be granted only to Company employees (including officers and directors who are also employees). Nonqualified stock options ("NSO") and stock purchase rights may be granted to Company employees and consultants. The Company has reserved 1,000,000 shares of common stock for issuance under the Plan. No person will be eligible to receive options for more than 250,000 shares in any fiscal year.

Options under the Plan may be granted for periods of up to ten years and at prices no less than 85% of the estimated fair market value of the shares on the date of grant, provided, however, that (i) the exercise price of an ISO shall not be less than 100% of the estimated fair market value of the shares on the date of grant, and (ii) the exercise price of an ISO granted to a 10% or more shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant. Most options granted under the Plan through December 31, 2003 vest over a five-year period.

Activity under the Plan is set forth below:

	Available for Grant	Number of Shares Outstanding	Weighted Average Exercise Price
<b>Balance at December 31, 2000</b>	384,608	486,432	\$6.36
Granted	(67,566)	67,566	\$4.73
Exercised	--	(6,200)	\$1.21
Cancelled	<u>24,800</u>	<u>(24,800)</u>	\$6.20
<b>Balance at December 31, 2001</b>	341,842	522,998	\$6.17
Granted	(203,900)	203,900	\$3.99
Exercised	--	(4,000)	\$1.28
Cancelled	<u>51,000</u>	<u>(51,000)</u>	\$1.94
<b>Balance at December 31, 2002</b>	188,942	671,898	\$5.87
Granted	(7,500)	7,500	\$4.15
Exercised	--	(3,000)	\$3.19
Cancelled	<u>19,666</u>	<u>(19,666)</u>	\$5.09
<b>Balance at December 31, 2003</b>	<u>201,108</u>	<u>656,732</u>	\$5.88

Information relating to stock options outstanding and exercisable at December 31, 2003 is as follows:

Options Outstanding				Options Vested and Exercisable	
Exercise Price	Number outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number outstanding	Weighted Average Exercise Price
\$2.75 - \$4.06	213,900	8.1	\$ 3.95	13,500	\$ 3.49
\$4.10 - \$5.74	77,000	3.9	\$ 4.71	58,825	\$ 4.62
\$6.00 - \$6.80	256,000	6.4	\$ 6.03	160,800	\$ 6.05
\$7.00 - \$11.45	<u>109,832</u>	3.7	\$ 7.76	<u>104,932</u>	\$ 7.79
	<u>656,732</u>			<u>338,057</u>	

### Employee Stock Purchase Plan

The Company has reserved 600,000 shares of Common Stock for issuance under the 1997 Employee Stock Purchase Plan (the "Purchase Plan"). Employees generally will be eligible to participate in the Purchase Plan if they are customarily employed by the Company for more than 20 hours per week and more than five months in a calendar year and are not (and would not become as a result of being granted an option under the Purchase Plan) 5% Shareholders of the Company. Under the Purchase Plan, eligible employees may choose each year to have up to 15% of their eligible annual compensation withheld to purchase the Company's common stock. Each offering period commences on the first trading day of each calendar quarter, or on such other date as the Board shall determine. The price at which the common stock is purchased under the Purchase Plan is 85% of the lesser of the closing price of the Company's common stock on the first day of the applicable offering period or on the last day of that purchase period. The Purchase Plan will terminate after a period of ten years unless terminated earlier as permitted by the Purchase Plan. During the years ended December 31, 2003, 2002 and 2001, 20,826, 15,091 and 22,958 shares of common stock were purchased under this plan at a weighted-average price of \$4.12, \$2.68 and \$5.77, respectively.

### Fair Value Disclosures

This information is required to be determined as if the Company had accounted for its employee stock options (including shares issued under the Employee Stock Purchase Plan, collectively called options) as defined by SFAS No. 123. The fair value of options reported below has been estimated at the date of grant using the Black-Scholes option-pricing model for 2003, 2002 and 2001 using the following assumptions:

	Stock Options			Employee Stock Purchase Plan		
	2003	2002	2001	2003	2002	2001
Risk-free interest rates	2.1 – 3.6%	4.3 - 5.1%	4.0 - 4.9%	0.8% - 1.1%	0.9% - 1.8%	5.4% - 6.6%
Expected lives (in years)	5	5	5	0.25	0.25	0.25
Expected dividend yield	1.8%	1.9%	1.0%	1.9%	1.9%	1.0%
Expected stock price volatility	43.5%	43.1%	47.8%	43.5%	43.1%	47.8%

The weighted-average estimated fair value of options granted during the year 2003, 2002 and 2001 were \$1.72, \$1.43 and \$1.78, respectively. The weighted-average estimated fair value of employee stock purchase rights granted under the Employee Stock Purchase Plan were \$0.66, \$.57 and \$1.10 in 2003, 2002 and 2001, respectively. The effect on earnings per share of using the fair value of options is disclosed in Note 1 above.

### NOTE 9 – RETIREMENT SAVINGS PLAN

The Company adopted a defined contribution retirement savings plan under Section 401(k) of the Internal Revenue Code. This plan covers substantially all employees who meet minimum age and service requirements and allows participants to defer a portion of their annual compensation on a pre-tax basis. The plan allows employer's matching contributions equal to 50% of employees' contributions subject to a maximum of 6% of employees' compensation. Contributions to the plan may be made at the discretion of the Board of Directors. The Company made no contributions in 2003 or 2002 and contributed \$219,000 in 2001.

## NOTE 10 - SEGMENT AND GEOGRAPHIC INFORMATION

The Company is organized into two business segments: Safety Products Group, whose products include safety light curtains, safety interlocks and relays, safety mats and controllers, safety contact strips, and optical profiling scanners, and installation services, and Automation Products Group, whose products include photoelectric and fiberoptic sensors, control components, power monitoring electronics, defense electronics, industrial control microcomputers, peripherals and software, level and flow sensors, non-contact ultrasonic sensors and controllers, pressure transducers, digital pressure gauges, displacement and velocity transducers and pressure comparators.

Financial information for each product group for the years ended December 31, 2003, 2002 and 2001 follows:

	Safety Products	Automation Products
<u>2003</u>		
Sales	\$46,708	\$ 8,786
Group operating profit (loss)	\$ 2,265	\$ (1,769)
Total assets	\$32,469	\$ 5,210
Capital expenditures	\$ 636	\$ 799
Depreciation and amortization	\$ 1,552	\$ 1,140
<u>2002</u>		
Sales	\$43,493	\$ 7,714
Group operating profit (loss)	\$ 2,419	\$ (1,675)
Total assets	\$28,646	\$ 9,246
Capital expenditures	\$ 1,101	\$ 122
Depreciation and amortization	\$ 1,517	\$ 1,114
<u>2001</u>		
Sales	\$40,085	\$ 8,968
Group operating profit (loss)	\$ (846)	\$ (1,628)
Total assets	\$25,526	\$ 8,674
Capital expenditures	\$ 859	\$ 151
Depreciation and amortization	\$ 1,920	\$ 346

The Company's sales by geographic location of customers in 2003 were: North America – \$53,356,000, Europe - \$1,093,000 and Asia - \$1,045,000. Foreign sales represented 12% of sales in 2003 and less than 10% of sales in each of 2002 and 2001.

## NOTE 11 - CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash, cash equivalents, short-term investments and trade accounts receivable. The Company places its cash and cash equivalents in a variety of money market accounts. The Company further limits its exposure to these investments by placing such investments with various high quality financial institutions. The Company routinely performs evaluations of these financial institutions. The Company offers credit terms on the sale of its products to its customers in the normal course of business. The Company performs ongoing credit evaluations of its customers' financial condition and, generally, requires no

collateral from its customers. The Company maintains an allowance for uncollectible accounts receivable based upon the expected collectability of all accounts receivable. No customer accounted for more than 10% of accounts receivable at December 31, 2003, 2002 or 2001.

The Company operates principally in the United States. The Company's operations in Germany are insignificant to the Company as a whole.

## NOTE 12 – COMMITMENTS AND CONTINGENCIES

The Company leases certain office and manufacturing space and other equipment under noncancellable operating leases. At December 31, 2003, future minimum payments under these leases due in the years 2004 through 2005 were approximately \$1,265,000 and \$1,083,000 and \$230,000 per year from 2006 to 2008. Of these amounts \$1,026,000 in 2004, \$951,000 in 2005 and \$126,000 from 2006 to 2008 was related to lease agreements with the Parent or an affiliate of the Parent.

Rent expense under operating lease agreements was approximately \$1,168,000 in 2003, \$1,123,000 in 2002, and \$1,007,000 in 2001. Of these amounts, \$963,000, \$974,000 and \$900,000 were related to lease agreements with the Parent or an affiliate of the Parent.

From time to time, the Company is involved in litigation in the normal course of business. Management believes that the outcome of existing matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

The Company offers warranties on certain products and records a liability for the estimated future costs associated with warranty claims, which is based upon historical experience and the Company's estimate of the level of future costs. A reconciliation of the changes in the Company's warranty liability for the years ended December 31, 2003 and 2002 follows (in thousands):

	Year Ended December 31,	
	2003	2002
Warranty accrual at the beginning of the year	\$241	\$278
Accruals for warranties issued during the year	163	122
Expenses incurred during the year	(183)	(159)
Warranty accrual at the end of the year	<u>\$221</u>	<u>\$241</u>

As permitted under Oregon law the Company has agreements whereby the Company indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was serving at the Company's request in such capacity. The indemnification term is for the period that the officer or director is serving in such capacity or is subject to any possible claim or action by reason of the fact that the Indemnitee was serving in that capacity. The maximum potential amount of future payments by the Company could be unlimited; however the Company has a director and officer insurance policy that limits the Company's exposure and enables the Company to recover a portion of any future amounts paid. As a result of the insurance policy coverage, the Company believes that the estimated fair value of these agreements is minimal.

**Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**Item 9A. CONTROLS AND PROCEDURES**

(a) *Evaluation of disclosure controls and procedures.* Based on their evaluation as of December 31, 2003, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

(b) *Changes in internal controls.* There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

**PART III**

Certain information required by Part III is omitted from this Report in that the registrant will file a definitive Proxy Statement for its 2003 Annual Meeting of Shareholders pursuant to Regulation 14A (the "Proxy Statement") no later than 120 days after the end of the fiscal year covered by this Report, and certain information included therein is incorporated herein by reference.

**Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information required by this Item concerning the Company's directors and the Company's executive officers is incorporated by reference to the sections entitled "Nominees" and "Management", respectively, appearing in the Company's Proxy Statement for its 2003 Annual Meeting of Shareholders.

**Item 11. EXECUTIVE COMPENSATION**

The information required by this Item is incorporated by reference to the sections entitled "Executive Compensation" and "Report of the Compensation Committee" appearing in the Proxy Statement for its 2003 Annual Meeting of Shareholders.

**Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The information required by this Item is incorporated by reference to the sections entitled "Security Ownership of Certain Beneficial Owners and Management" and "Equity Compensation" appearing in the Proxy Statement for its 2003 Annual Meeting of Shareholders.

### **Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information required by this Item is incorporated by reference to the sections entitled "Certain Relationships and Related Transactions" appearing in the Proxy Statement for its 2003 Annual Meeting of Shareholders.

### **Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by this Item is incorporated by reference to the sections entitled "Principal Accountant" appearing in the Proxy Statement for its 2003 Annual Meeting of Shareholders.

## **PART IV**

### **Item 15 EXHIBITS LIST AND REPORTS ON FORM 8-K.**

(a) The following documents are filed as a part of this Report:

#### **1. FINANCIAL STATEMENTS**

Reference is made to the index appearing in Item 8(a) of this report.

#### **2. EXHIBITS AND EXHIBIT INDEX:**

Exhibit 3.1	Articles of Incorporation, as amended, are incorporated by reference to the Registrant's Form 10- K for the year ended December 31, 1988, Exhibit 3.1.
Exhibit 3.3	By-Laws are incorporated by reference to the Registrant's Form 10- K for the year ended December 31, 1985, Exhibit 3.
Exhibit 4.1	1997 Employee Stock Purchase Plan is incorporated by reference to the Registrant's Registration Statement on Form S-8 dated October 2, 1998.
Exhibit 4.2	1997 Stock Plan is incorporated by reference to the Registrant's Registration Statement on Form S-8 dated October 2, 1998.
Exhibit 10.1	Lease agreement dated February 21, 1995 for 6550 Dumbarton Circle, Fremont, California 94555, is incorporated by reference to the Registrant's Form 10-KSB for the year ended December 31, 1994, Exhibit 10.4.
Exhibit 10.2	Bank agreement dated November 29, 1994 with Bank of The West is incorporated by reference to the Registrant's Form 10-KSB for the year ended December 31, 1994, Exhibit 10.3.
Exhibit 10.3	Amendment dated June 28, 2003 to Bank Agreement dated November 29, 1994 with Bank of the West.
Exhibit 10.4	Lease agreement dated June 1, 2002 with Scientific Technology Incorporated for 1025 W. 1700 N., Logan Utah 84321 is incorporated by reference to the Registrant's Form 10-KSB for the year ended December 31, 2002, Exhibit 10.4.
Exhibit 21.1	Subsidiaries of the Registrant.
Exhibit 23.1	Consent of PricewaterhouseCoopers LLP, Independent Accountants.
Exhibit 24.1	Power of Attorney (included on page 36).
Exhibit 31.1	Certification of Chief Executive Officer Pursuant To Section 302(a) of the Sarbanes Oxley Act of 2002
Exhibit 31.2	Certification of Chief Financial Officer Pursuant To Section 302(a) of the Sarbanes Oxley Act of 2002

Exhibit 32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act Of 2002
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All other exhibits for which provision is made in Regulation S-K of the Securities and Exchange Commission are not required under the related instructions or are inapplicable, and therefore have been omitted.

(b) A Report on Form 8-K was filed on November 4, 2003 furnishing the Company's Earnings Release for the quarter ended September 30, 2003 to the Securities and Exchange Commission.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Exchange Act, the registrant has caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

### **SCIENTIFIC TECHNOLOGIES INCORPORATED**

Dated: March 29, 2004

By /s/ Anthony R. Lazzara  
Anthony R. Lazzara, Chairman of the Board

### **POWER OF ATTORNEY**

**KNOW ALL MEN BY THESE PRESENTS**, that each person whose signature appears below constitutes and appoints Anthony R. Lazzara and Joseph J. Lazzara, jointly and severally, his attorney-in-fact, each with the power of substitution, for him in any and all capacities, to sign any amendments to this Report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or his substitute or substitutes, may do or cause to be done by virtue hereof.

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Anthony R. Lazzara</u> 2004 Anthony R. Lazzara	Chairman of the Board	<u>March 29,</u>
<u>/s/ Joseph J. Lazzara</u> 2004 Joseph J. Lazzara	President, Chief Executive Officer, Treasurer, Director (Principal Executive Officer)	<u>March 29,</u>
<u>/s/ James A. Lazzara</u> James A. Lazzara	Vice President, Secretary and Director	<u>March 29, 2004</u>
<u>/s/ James A. Ashford</u> James A. Ashford	Vice President and Director	<u>March 29, 2004</u>
<u>/s/ Richard S. Baldwinson</u> Richard S. Baldwinson	Director	<u>March 29, 2004</u>
<u>/s/ Carl H. Frei</u> Carl H. Frei	Director	<u>March 29, 2004</u>
<u>/s/ Bernard J. Ploshay</u> Bernard J. Ploshay	Director	<u>March 29, 2004</u>
<u>/s/ Richard O. Faria</u>	Vice President and Chief	<u>March 29, 2004</u>

Richard O. Faria

Financial Officer (Principal Financial Officer)

**SCIENTIFIC TECHNOLOGIES INCORPORATED**

**EXHIBITS**

**TO**

**Annual Report on Form 10-K  
Year ended December 31, 2003**

## **EXHIBITS - TABLE OF CONTENTS**

	<u>Page</u>
Exhibit 10.3 - Amendment dated June 16, 2003 to Bank Agreement dated November 29, 1994	<u>44</u>
Exhibit 21.1 - Subsidiaries of the Registrant	<u>49</u>
Exhibit 23.1 - Consent of Independent Accountants	<u>50</u>
Exhibit 24.1 - Power of Attorney (included on page 39)	
Exhibit 31.1 - Certification of Chief Executive Officer Pursuant To Section 302(a) of the Sarbanes-Oxley Act of 2002	51
Exhibit 31.2 - Certification of Chief Financial Officer Pursuant To Section 302(a) of the Sarbanes-Oxley Act of 2002	<u>52</u>
Exhibit 32.1 - Certification Of Chief Executive Officer And Chief Financial Officer Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of The Sarbanes-Oxley Act of 2002	<u>53</u>